Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Burton | Analyst: Colin Stevens | Bill Number: SB 1239

Related Bills: SB 723 (Ch. 874, Stats. 1993) | Telephone: 845-3036 | Introduced Date: APTBA

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Exemption/Alien Corporation Qualifying Investment Security Income/Doesn't Apply To Corporations In Unitary Business

SUMMARY

Under the Bank and Corporation Tax Law (B&CTL), this bill, as proposed to be amended, would provide that income, gain or loss from stocks or securities received by an alien corporation, as defined, that is derived from trading stocks or securities for its own account, as defined under federal law, would not be treated as income derived from California sources.

EFFECTIVE DATE

This bill specifies that it would apply to income years beginning on or after January 1, 1999.

SPECIFIC FINDINGS

Under federal law, a nonresident alien individual or foreign corporation that is engaged in a trade or business within the United States is subject to U.S. taxation at graduated rates of tax on its net income that is effectively connected with conduct of that trade or business. Under a "safe harbor" exception to the engaged in a United States trade or business rule, foreign persons that trade in stocks or securities for their own accounts are not treated as engaged in a U.S. trade or business.

This exception covers trading in stocks, securities, and options to buy or sell stocks or securities. For a foreign corporation to qualify for the safe harbor, it must not be a dealer in stock or securities. For tax years beginning before January 1, 1998, if the principal business of the foreign corporation is trading in stock or securities for its own account, the safe harbor generally does not apply if the principal office of the corporation is in the United States.

In general, a corporation organized under the laws of a foreign country (an offshore company) is subject to the federal income tax on all of its income that is effectively connected with a trade or business conducted within the United States. For tax years beginning before January 1, 1998, an offshore company engaged in trading stock or securities in the United States was not treated as engaged in a trade or business in the United States, unless its principal office was in the United States. "Principal office" was not statutorily-defined, but Treasury regulations provided that an offshore investment company would not be deemed to have its principal office located in the United States if all or a substantial portion of ten administrative functions were carried on in an office outside of the United States.

Board Position:			Department Director	Date
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Under Treasury regulations that apply to both corporations and partnerships, the determination of the location of the entity's principal office turns on the location of various functions relating to operation of the entity, including communication with investors and the general public, solicitation and acceptance of sales of interests, and maintenance and audits of its books of account. Under the regulations, the location of the entity's principal office does not depend on the location of the entity's management or where investment decisions are made.

To promote increased investment in United States capital markets, the Taxpayer Relief Act of 1997, effective for taxable years beginning after December 31, 1997, amended federal law to eliminate the reference to a principal office in the United States. Thus, **under federal law**, an offshore investment company may now maintain a principal office in the United States without being deemed to be engaged in a trade or business in the United States for federal tax purposes (and thus subject to United States tax at graduated rates).

In general, **California law** taxes California residents on income from all sources. Nonresidents of California are subject to tax on all income derived from sources within this state. The state does not conform to any federal nonresident alien rules, since it has unique rules relating to nonresidents of California.

Current state law provides that California source income earned by specified nonresident taxpayers from the buying, selling or holding of qualified investment securities is not considered as derived from California sources and is not income arising through a partnership which qualifies as an investment partnership in California, as defined. The exclusion from income applies regardless of whether the partnership has a usual place of business in the state. Such income includes income from interest, dividends, or gains and losses from qualifying investment securities.

An investment partnership is one that has at least 90% of its partnership’s costs of its total assets in qualifying securities, deposits at banks or other financial institutions, and office space and equipment reasonable to carry on its activities. It also can derive no less than 90% of its gross income from interest, dividends, and gains from the sale or exchange of qualifying investment securities. An interest in a partnership is not a qualified investment security unless the partnership is an investment partnership.

Qualifying investment securities include: common stock, including preferred or debt securities convertible into common stock, and preferred stock; bonds, debentures and other debt securities; foreign and domestic currency deposits and securities convertible into foreign securities; mortgage-or asset-backed securities secured by governmental agencies; repurchase agreements and loan participations; foreign currency exchange contracts and forward and futures contracts on foreign currencies; stock and bond index securities and futures contracts, and other similar financial securities and futures contracts on those securities; regulated futures contracts; and options to purchase and sell any of the preceding qualified investment securities, except regulated futures contracts.

Current **state law limits** those that can be considered as investment partners to the following specified nonresident taxpayers:

- an individual whose only contact with the state, with respect to qualified investment securities, is through a California broker, dealer or investment adviser;
- a partner, including a bank or corporation, in an investment partnership;
- the beneficiary of a qualifying estate or trust whose investment account is managed by a corporate fiduciary located in the state; or
- a unit holder in a regulated investment company.

The exclusion does not apply if the investments are interrelated with any other business activity of the nonresident that is distinct and separate from the investment activity and is conducted by the nonresident in California, or if the investments are acquired with the working capital of a California trade or business. A bank or corporation is not allowed to exclude the income if it participates in the management of the investment activities or is engaged in a unitary business with another taxpayer that participates in managing the investment activities or has income from California sources.

California does not generally conform to the U.S. income sourcing rules for foreign corporations. However, for California purposes, corporate taxpayers that have a water's-edge election in force are required to use federal rules to determine U.S. source income, including rules for foreign corporations. **Existing state law** requires corporations with activities both inside and outside California to combine all activities when determining business income apportionable to the state for tax purposes.

The B&CTL requires corporations that are members of a unitary business with activities both within and outside California to combine all activities when determining business income apportionable to the state for tax purposes. Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of the income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales. The California income is then apportioned to the members which are taxable in California, who each retain a separate tax identity and liability.

The B&CTL allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

The B&CTL provides for the use of an apportionment formula when assigning business income of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales. Each factor is the ratio of in-state activity to worldwide activity. The combined report is used to determine the apportionment percentage and the amount of income attributable to California.

Existing state law provides that every corporation that is "doing business" in California is subject to the **corporation franchise tax**.

"Doing business" is defined in the code as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. The franchise tax is not a tax on income. Rather, the franchise tax is a tax, measured by net income, for the privilege of doing business in the state. The corporate franchise tax rate is 8.84% of net income, or the $800 minimum franchise tax, whichever is greater. Every corporation that is qualified to do business, is doing business in this state (whether organized in-state or out-of-state), or is incorporated in California is subject to the minimum franchise tax.

Under **existing state law,** if a corporation is "doing business" in this state the income that may be apportioned to California for tax purposes includes the income received while engaged in activities in this state and income received from merchandise orders that resulted from those activities in this state.

Alternatively, **existing state law** provides that corporations not organized in or qualified to do business in California, but that derive income from California sources and are not "doing business" in California, are subject to the **corporation income tax**. This tax is set at 8.84% by reference in the code to the corporate franchise tax rate. The minimum franchise tax does not apply to corporations subject to the corporation income tax.

This bill would provide that income, gain or loss from stocks or securities received by an alien corporation, as defined, trading stocks or securities for its own account, as defined under federal law, would not be treated as income derived from or attributable to California sources.

This bill would specify that an "alien corporation" trading in stocks or securities for its own account is not "doing business" in this state and not liable for the franchise or minimum franchise tax under Chapter 2 of Part 11.

This bill also would specify that a dealer in securities would not be allowed this exclusion.

For purposes of this bill:

"Alien corporation" means a corporation organized under the laws of a country, or political subdivision thereof, other than the United States.

"Dealer in securities" means a dealer in stocks or securities as defined under the Internal Revenue Code.

These sourcing rules would not apply to an alien corporation that itself has, or that is engaged in a unitary business with another corporation that has, income derived from or attributable to California sources other than the "trading for their own account in stock or securities" income added by this bill.

Policy Considerations

This bill would essentially conform California law to federal law with respect to alien corporations trading for their own account and would provide treatment for alien corporations similar to the treatment allowed to California investment partnerships.

This bill could be interpreted to provide an advantage to alien corporations relative to corporations organized in other states of the United States.

Implementation Considerations

This bill is not expected to significantly impact the department's programs and operations.

FISCAL IMPACT

Departmental Costs

This bill is not expected to result in significant costs to the department.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in negligible revenue effects in any given year beginning in 1999-00. Foreign mutual funds (those incorporated under laws of foreign countries) are not currently managed from California. Without this bill to clarify the pass-through nature of such a fund organized in corporate form, these funds would not be managed from California.

The bill would be effective with income years beginning on or after January 1, 1999, with enactment assumed after June 30.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The number of foreign mutual funds that would be actively managed from California and the extent of each company's factor presence in the state would determine the revenue impact of this bill. To the extent these funds establish nexus in California, their limited factor presence would determine the level of taxation. Under these circumstances, the tax effect would be a minimum tax of $800 times the number of such foreign corporations.

Federal estimates in the Taxpayer Relief Act of 1997 for the provision allowing foreign mutual funds to be managed in the United States were negligible, less than $500,000 annually.

BOARD POSITION

Pending.